The Code Of Ethics

The member and candidates for the CFA designation must:

• Act with integrity, competence, diligence, respect, and in an ethical manner with the public, clients, prospective clients, employers, employees, colleagues in the investment profession, and other participants in the global capital markets

• Place the integrity of the investment profession and the interests of clients above their own personal interests

• Use reasonable care and exercise independent professional judgment when conducting investment analysis, making investment recommendations, taking investment actions, and engaging in other professional activities.

• Practice and encourage others to practice in a professional and ethical manner that will reflect credit on themselves and the profession.

• Promote the integrity of, and uphold the rules governing, capital markets.

• Maintain and improve their professional competence and strive to maintain and improve the competence of other investment professionals
CFA Institute Soft Dollar Standards

• Definitions
  – *Soft Dollars* refers to the commissions generated by both agency and principal trade
  – *Agency Trade* is a transaction that involves a payment of commission
  – *Principal Trade* refers to transaction that involves the use of discount or spreads
  – *Best Execution* refers to executing Client transaction so that Client bears the minimum cost
  – *Brokerage* is the amount retained by broker for his services
  – *Client Directed Brokerage Arrangement* is an arrangement in which Client asks that the manager direct all the trade in his/her account through a specific broker in exchange of a benefit in addition to execution service.
  – *Investment Manager-Directed Brokerage Arrangement* refers to Proprietary and Third-Party Research Arrangements
  – *Mixed Use Research* refers to products or service provided by the broker to investment manager that can be used both for the investment decision making process and also the management of the investment firm.
  – *Research* refers to products/service by the broker, the primary use of which is for the investment decision making process and not the management of the investment firm. It includes both proprietary and third party research
  – *Proprietary Research Arrangement* is an arrangement in which the investment manager directs the securities transaction of client account to broker in exchange of the research provided by the in house staff of brokerage firm
CFA Institute Soft Dollar Standards

• Definitions (contd.)
  – *Third Party Research Arrangement* is an arrangement in which the investment manager directs the securities transaction of client account to broker in exchange of the research which has been generated by an entity other than the executing broker
  – *Soft Dollar Arrangement* refers to a research and benefits provided by the broker to the investment manager and client for directing the trade to broker
CFA Institute Soft Dollar Standards

• The key principals of Soft Dollar Standards are :-
  – Brokerage is the property of client
  – Investment manager should seek to obtain best execution, minimize transaction cost and use Client
    Brokerage to benefit the clients.

• CFA Institute Soft Dollar Standards are principals intended to ensure :-
  – Full and Fair disclosure of investments manager’s use of client brokerage
  – Consistent presentation of information
  – Uniform Disclosure and Record Keeping
  – High Standards of Ethical Practice

• Following set of principals should be considered by investment manager to comply :-
  – The investment manager is fiduciary and must disclose all the benefits manager receiver through client
    brokerage
  – Third party research and proprietary research in soft dollar arrangement are treated to be same because
    both are paid from client brokerage
  – Research should be purchased by client brokerage only if it helps in the investment decision making
    process of the manager and not for the management of the firm
  – When in doubt research should be paid by the investment manager and not from the client brokerage
CFA Institute Soft Dollar Standards

Requirements and Recommendations:

1. General
   • Required
     – Soft dollar practices must always benefit the client and put clients interest above employer's or investment manager’s interest
     – Allocation of client brokerage should not be based on the amount of client referrals directed by the broker to investment manager

2. Relationship with Clients
   • Required
     – Investment Manager must disclose to the clients that they may engage in Soft Dollar arrangement beforehand
   • Recommended
     – It is permissible to use client brokerage form agency trade that may not directly benefit the client but over the time client should benefit from the research
     – If no fiduciary regulation is applicable, It is permissible use client brokerage derived from Principal trade to benefit other client accounts as long it is disclosed to client and prior consent is taken
3. Selection Of Brokers

Selecting broker is a key component of the Investment Manager ability to add value for the client. Failure to obtain Best execution may result in impaired performance

• Required
  – Investment Manager must consider broker’s ability of Best execution before selecting a broker

• Recommended
  – To evaluate Brokers capability of Best execution the Investment Manager must consider financial responsibility of broker, Responsiveness, Commission rate or spread and range of service offered by Broker

4. Evaluation Of Research

• Required
  Following criteria must be followed to determine whether the client brokerage can be used to pay for Research
  – Research should meet the definition under the standard
  – Research should benefit the client
  – Basis of determination should be documented
CFA Institute Soft Dollar Standards

– If no fiduciary regulation is applicable, client brokerage derived from Principal trade may be used to benefit other client accounts as long it is disclosed to client and prior consent is taken.

– In the case of Mixed-Use Research, make a justifiable allocation of cost of the research based on its expected usage. Only pay that portion of research from Client brokerage that is used in the Investment Decision making process. Annually reevaluate the mixed use research.

5. Client Directed Brokerage

• Brokerage is an asset of the client so Client directed brokerage doesn’t violate the duty of investment manager.

• Required
  – Manager must not use brokerage from other client account to pay for product or service purchased under any Client Directed Brokerage agreement.

• Recommended
  – Disclose to the client that the Manager’s duty is to seek Best Execution continuously and also that the portion of Brokerage may affect the ability of Manager to seek best execution and obtain adequate Research.
6. Disclosure

• Required
  
  Investment Manager must :-
  
  – Disclose in plain language their soft dollar practices. Address principal trades
  – Disclose the type of research received through proprietary or third party research agreements, the extent of its use and whether any affiliated Broker is involved
  – Provide to the client annually a statement that Soft Dollar Arrangements conform to the CFA Institute Soft Dollar Standard
  – Disclose to the client that the additional information of the Standard are available on request. Additional information provided upon request includes a detailed description of what firms benefits through its Soft Dollar arrangements, broker who provided the service and commissions made for the client account

• Recommended
  
  – Manager should provide a description of product and service bought using the brokerage from the clients account
  – Provide the total amount of brokerage from all account which are at the discretion of the Investment Manager
CFA Institute Soft Dollar Standards

7. Record Keeping
   • Required
     Investment Manager must maintain all the records that:
     – Meet legal requirements
     – Meet Disclosure standard requirements
     – Document arrangements that obligate the Investment manager to generate specific amount of Brokerage
     – Document client arrangements pertaining to Client Direct Brokerage agreements
     – Document agreement with broker related to Soft Dollar Arrangements
     – Document transaction with Broker related to Soft Dollar Agreement
     – Document the basis of allocation of Client brokerage when used to pay for Mixed Use product or services
     – Indicate how the products through the Soft Dollar Arrangement are used in the Investment decision making
     – Include Client disclosure and authorization copies
Permissible Research Guidance
CFA Institute Soft dollar Standards sets forth a 3 level analysis to assist the Investment Manager in determining that whether a product or service is Research that can be purchased with Client Brokerage

• **Level 1 – Define the product or Service**

• **Level 2 – Determine Usage**

• **Level 3 – Mixed Use Analysis**
CFA Institute Soft Dollar Standards

Level 1

Define the product or service constituting the Research

Level II

Will the primary use of the Research directly assist the Investment Manager in its Investment Decision-Making Process and not in the management Investment firm?

Yes

Research cannot be paid for with Client Brokerage

No

Level III

Is less than 100% of the Research involved used by the Investment Manager to directly assist in its Investment Decision-Making Process?
CFA Institute Soft Dollar Standards

Level III

Determine the portion of the Research that may be paid for with the Client Brokerage

A portion of the Research is used To directly assist the Investment Manager in its Investment Decision-Making Process

Research can be paid for with Client Brokerage

A portion of the Research is not used to directly assist the Investment Manager in its Investment Decision-Making Process

Research cannot be paid for with Client Brokerage
Case Study

Sally and John are discussing the CFA Soft Dollar standards on client directed brokerages. Sally states that the most important criteria while selecting a broker is the value added services that they provide to the firm. She believes that most brokers provide similar services and they can only be ranked through the value-added services that they provide. John states that the ability to provide competitive quotes with very low execution costs should be the determining factor. Their client an endowment fund created to provide for the education of Mr. Scully’s two sons directs their firm to route some of their trades through a specific broker. The broker in return provides Mr. Scully with economic data which he uses to keep himself informed about the general macro environment.

Sally works for an investment management firm Alpha Securities. The firm has a policy of selecting brokers only after they have been thoroughly vetted by the management. The company management uses a checklist to ensure that their clients always get the best services from their brokers. One of the criteria for selecting a broker is that they should have a minimum turnover of more than $5 mn. The firm also decides to use a part of their brokerages to pay for a new software that has been recently released in the market. The software provides tools which the firm uses to screen stocks that can provide good appreciation in the future. The stocks are screened based on the criteria set by their clients.

John works with another firm Omega Securities. The firm decides to pay for a risk management software using client brokerage. The risk management software will be used for assessing the risk of the portfolio and for managing any potential loss in portfolio value.
Case Study Questions

1. State whether Sally and John are most likely

<table>
<thead>
<tr>
<th>Sally</th>
<th>John</th>
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<tbody>
<tr>
<td>A</td>
<td>Incorrect</td>
</tr>
<tr>
<td>B</td>
<td>Correct</td>
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<tr>
<td>C</td>
<td>Correct</td>
</tr>
</tbody>
</table>

2. When Sally states that VAS is the most important criteria for ranking the brokerages. She is most likely
   A. Incorrect, as the most important criteria is trade execution at the lowest cost
   B. Correct, as VAS can be used to find out the best brokers
   C. Incorrect, as the brokers should always be ranked based on their turnover

3. When Alpha Securities uses client brokerages to pay for buying software used to screen stocks they are most likely
   A. Incorrect, based on Level 1 analysis
   B. Incorrect, based on Level 2 analysis
   C. Correct, as the software is used for investment making decision
4. When Omega Securities uses client directed brokerage to buy risk management software they are most likely

A. Correct, as risk management is important while making any portfolio management decision
B. Incorrect, as the software will not be directly used for any investment management activity
C. Incorrect, as the software does not classify as an investment management tool according to the Level 2 analysis.
1. A.
Sally is incorrect when she states that she ranks brokers according to the value-added services that they provide. According to the CFA Soft Dollar standards a broker should only be selected on the basis of their trade execution costs. John is correct when he states that competitive quotes and low execution costs should be the determining factor.

2. A.
CFA Soft Dollar standards state that a broker should be selected on the basis of their execution costs. And that the clients interest should always be the most important criteria for selecting the broker.

3. C.
The software classifies as a research tool based on Level 1 analysis as it is defined as a tool that is used for making investment decisions. We move to Level 2 analysis where we determine that the primary use of the software is for investment making decision and it is not used for firm management. Then a Level 3 analysis is used to determine what percentage of the software is used for making investment decisions. As the software can be classified as being used for making investment making decision the firm can use client brokerage for buying it.

4. A.
The risk management software is not used for portfolio selection. But risk management is an important part of portfolio management. Hence the firm should determine what part of the software will be used for managing the risk of the clients. Only that part will be paid through client brokerage.